BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Address the Gas Utilities' Incentive Mechanisms and the Treatment of Hedging Under Those Incentive Mechanisms.	Rulemaking 08-06-025 (Filed June 26, 2008)

COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES IN RESPONSE TO ADMINISTRATIVE LAW JUDGE THOMAS R. PULSIFER'S JANUARY 15, 2009 RULING

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I. INTRODUCTION

Pursuant to the January 15, 2009 and January 21, 2009 Administrative Law Judge's Rulings, the Division of Ratepayer Advocates (DRA) hereby submits additional information on issues involving the treatment of natural gas hedging under the utility incentive mechanisms.

II. DISCUSSION

A. Customer Risk Tolerance – The Survey Approach

In his January 15 Ruling, ALJ Pulsifer indicated that a further development of the record is needed regarding issues relating to customer risk tolerance for gas price volatility. See January 15 Ruling at 1. DRA expects that the report on the recent survey performed by Pacific Gas and Electric Company (PG&E) and its consultant, Socratic Technologies, will not be available until March 2009, or perhaps later. DRA is therefore unable to comment on the report or its conclusions, or contribute to the development of the Commission's record in this context. Nonetheless, what is known to DRA is that PG&E's survey, by design, was not a 'random' survey. Rather, PG&E's survey-takers were comprised of volunteers from an internet pool of professional survey-takers who were paid $5.00 each for taking the survey.

PG&E and Socratic Technologies plan to use the conjoint analysis technique for mining the survey data. To DRA's knowledge, conjoint analysis, if not applied appropriately, can yield erroneous conclusions.[1] Therefore, DRA urges the Commission to carefully review the use and limitations of the conjoint analysis technique, and the conclusions drawn from such an analysis. Regardless, the jury is still out on a conclusive assessment of customer risk tolerance in PG&E's territory. Notwithstanding, DRA awaits the report's findings.

With respect to requiring a similar study to be performed in Southern California Gas Company's (SoCalGas) territory, DRA suggests that the Commission review the approach, results, conclusions, limitations, critiques, if any, and the overall usefulness of the PG&E survey and study before requiring SoCalGas to conduct one, either similar or dissimilar to the PG&E survey, in its territory.

The Ruling also asks whether a determination of SoCalGas' customer risk tolerance should be made annually, or each time the utility files for approval of a hedging plan. DRA does not believe that either approach is viable. In PG&E's case, one of the reasons that they used volunteer professional survey-takers from an internet pool was the lower cost of such a survey. A random survey of PG&E's core ratepayers would have been cost-prohibitive as it would have entailed not only the cost of the survey itself but also the cost of educating 1,500 to 2,000 survey-takers on hedging on a one-on-one basis over the telephone. DRA is also concerned that the results of such a random survey would most likely be stale by the time a survey is performed and its results have gone through a possibly lengthy vetting process in any Commission proceeding. DRA therefore believes that it is not feasible to determine customer risk tolerance levels that can be used by the Commission and/or the parties either on an annual basis or each time the utility files for Commission approval of a hedging plan. DRA's view is that the Commission should not rely on customer surveys regardless of whether the survey-takers

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[1] "Powerful, user-friendly software gives us opportunities to make mistakes we may not even be aware of. If you want to do conjoint analysis right, be aware of the ways you can do it wrong." --- Dick McCullogh, A User's Guide to Conjoint Analysis.

are randomly chosen and interviewed by telephone or whether they are volunteers from an internet pool of professional survey-takers. In summation, DRA believes that the customer survey approach on an ongoing basis as that envisioned in the context of the ALJ's question will be both burdensome and cumbersome, at best, and of very limited value because the results will be stale by the time the data are put to use.

B. Optional Customer Tariffs Based on Varying Risk Tolerances

The January 15 Ruling also solicited comments on the merits of exploring the design of optional tariff plans to provide core customers a choice between paying a more stable commodity rate (which recovers hedging costs) and a rate that is subject to greater volatility (but which excludes hedging costs). See ALJ Ruling at 3-4. While DRA supports the underlying concept suggested in ALJ Pulsifer's solicitation, it is not clear whether such an approach would be feasible in practice.

Under the portfolio approach, PG&E and SoCalGas would be required to provide two portfolios. There are both positives and negatives with this approach. The positive of such an approach is that it could offer customers the choice of a fully hedged, stable price instead of the current market-based price. However, there is a concern that the portfolio approach may result in confusion and customer complaints, which DRA views as burdensome and may result in a public relations nightmare. Regardless of the level of hedging that customers might desire, they will most definitely want to know, in advance, just what they are getting for the hedging surcharge with which they are going to be burdened. DRA believes that neither SoCalGas nor PG&E can address this matter satisfactorily to any group of core customers because the hedged portfolio's final outcome will depend on a variety and mix of probabilities, options and swaps. No matter how PG&E and SoCalGas design their hedged portfolios, they are bound to produce a slew of customer complaints and dissatisfaction because those customers will invariably wonder -- after the fact -- whether or not they signed up for a raw deal. In fact, this would have been the likely outcome over the past year had customers chosen such a fully hedged portfolio over an unhedged portfolio. DRA is therefore uncertain of whether the separate portfolio approach is a viable solution to the hedging conundrum facing the Commission.

DRA notes that core customers of both PG&E and SoCalGas have access to balance payment plans that can provide customers with the bill stability that they might desire thus insulating them from market volatility in the gas markets. The Commission should require PG&E and SoCalGas to more aggressively market these programs particularly during those periods when the spot prices of natural gas are high.

C. Performance Benchmarks for Use as Hedging Incentive Measures

DRA is not optimistic that SoCalGas can design a benchmark exclusively for hedging on which SoCalGas is willing to place its bet. To DRA's knowledge, no such benchmark exists out there in the hedging universe. Regardless, DRA trusts that SoCalGas' hedging benchmark will also require SoCalGas to share in the risk. Having some skin in the game will ensure the Commission that SoCalGas will have its ratepayers' interests directly aligned with its own interests. Doing so will also ensure that utilities will take extra care to safeguard against a rogue trader of sorts within PG&E or SoCalGas that may at some time in the future, unbeknownst to both the Commission and utility management, find its hands on the steering wheel.[2] Hence, insulating SoCalGas from losses against any benchmark has been and will continue to be, simply put, a "deal breaker" for DRA.

If hedging can indeed be incentivized, then there is no compelling reason to create a special hedging benchmark. Hedging can be (and has been) satisfactorily accounted for inside of the existing incentive mechanisms in the past. Thus, SoCalGas will need to demonstrate why and how the existing Gas Cost Incentive Mechanism (GCIM) and Core

[2] Barings collapsed in 1995 after Nick Leeson, the bank's Singapore general manager of futures trading, lost 860 million pounds -- then worth $1.38 billion -- on Asian futures markets, wiping out the bank's cash reserves. The company had been in business for more than 230 years. More recently in 2007, French bank Societe Generale uncovered a $7.14 billion fraud by a single futures trader who used his knowledge of the internal security systems to conceal a scheme of elaborate fictitious transactions.

Procurement Incentive Mechanism (CPIM) are lacking in this regard and why a special hedging benchmark is needed at all. DRA is also concerned that any special hedging benchmark concocted by SoCalGas will only add to the complexity of gas procurement. DRA urges the Commission to ensure that any such special hedging benchmark designed by SoCalGas cannot be gamed.

With respect to Shell's approach to a hedging benchmark, aside from hand-waving at the policy level, Shell has not provided parties with any of the details of its approach as of yet, as noted in the ALJ Ruling. The workings of Shell's approach therefore are unclear to DRA. DRA believes that the devil is in the details. Without these details, DRA simply cannot accord Shell's proposal the air time for which it appears to yearn.

D. Treatment of Hedging: Part-Within-Part-Outside Incentive Mechanisms

Of all the approaches, DRA believes that a hybrid approach (*See* ALJ Ruling at 6-8) has the most appeal because it better aligns the interests of the ratepayers and shareholders. This approach ensures that utilities will act in the interest of ratepayers to achieve the lowest price of natural gas possible for California ratepayers. It will also ensure that utilities' shareholders earn a reward for developing a hedging plan that is both opportunistic and dynamic in that utilities can change their hedging plan at the flick of a wrist as markets change. By the Commission's approval of this approach, the utilities will once again manage their hedges more actively.

DRA previously suggested the inclusion of only 25% of the cost of all winter hedges within its GCIM for the SoCalGas 2006-2007 winter season, while the remaining 75% of the cost of all winter hedges would be handled outside of its GCIM. Ideally, DRA would have liked, and still would like, to see 100% of the winter hedges inside its GCIM. Nonetheless, DRA was of the opinion then, and still is, that shareholders' interests should be in line with those of ratepayers. DRA is therefore amenable to a 25%/75% split at this time. Notwithstanding the 25%/75% split as described above, DRA recommends that an annual cap of $10 million be placed on the winter hedging losses outside each of their incentive mechanisms. Under this prescription, (a) ratepayers would be annually responsible for the lower of 75% of the hedging outcome or $10 million, and (b) there would be no limit to the hedging inside the incentive mechanism. A $10 million cap such as this will ensure that utilities do not saddle ratepayers with large losses that have been abundantly evident in the post-Katrina era. DRA recommends that the utilities file a statement with their annual filings on how, if at all, the $10 million cap tied the utilities hands on hedging decisions, and demonstrate how a different cap would have yielded better results for ratepayers.

The Ruling also asked SoCalGas and PG&E to back cast the results under their respective incentive mechanisms assuming the 25%/75% split had been in place during the most recent three winter seasons. DRA awaits the results of the utilities' back casts. Nonetheless, DRA recommends extreme caution in deriving any conclusions from these back casts for the simple reason that the winter hedges during this 3-winter season period outside their incentive mechanisms were entered into under a diametrically different utility mindset than that which will prevail under the 25%/75% split going forward.

During the back cast period, utilities faced no shareholder exposure, and were totally insulated from adverse outcomes. Going forward, DRA would like them to manage their hedges more actively. These are extremely different operating mindsets. DRA would therefore urge the Commission to be mindful of deriving conclusions from the back casts in this context.

E. Effects of Potential Allocations of Gain/Loss Assigned to Shareholders

The final section of the ruling asks a number of questions related to possible alternative design of incentive risk sharing measures. *See* ALJ Ruling at 9-10. Existing incentive mechanisms provide for a cap on shareholder rewards inside their respective incentive mechanisms. On the reward side, the reward is capped at 1.5% of total annual commodity costs for SoCalGas, whereas the reward is capped at the lower of $25 million or 1.5% of total annual commodity costs for PG&E. There are no corresponding caps on ratepayer savings for either utility. On the loss side, there are no caps on both ratepayer and shareholder losses for both SoCalGas and PG&E. Thus there are no caps on rewards or losses for ratepayers. For utility shareholders, however, there is a reward cap, as stated above, but no cap on their losses. While at first blush, such a compact may appear to be uneven for shareholders, the fact of the matter is that lack of evenness between the caps on rewards and losses is not of real consequence.

Up until 2001, there were no caps on rewards and losses for either shareholders or ratepayers of both utilities. Utilities could hedge as they deemed prudent and issues regarding the 'appropriate level' of hedging did not exist. It was only after the spike in natural gas prices at the California border in 2001, when the GCIM mechanism yielded a gargantuan reward for SoCalGas, that DRA and SoCalGas 'mutually' agreed to place a cap on the reward.[3] Similarly, PG&E's CPIM was also modified to include a cap on shareholder rewards.[4] Even after the cap on the reward was put in place, utilities could hedge as they deemed appropriate, with no constraints. Neither PG&E nor SoCalGas have hit their reward caps since they were put in place. The intent of mutually placing a cap on the reward was to merely prevent the occurrence of a windfall, similar to that which occurred for SoCalGas in 2001 – a repeat occurrence that would have possibly threatened the continuation of the incentive mechanisms at large. Neither SoCalGas nor PG&E have indicated to DRA that the caps on the reward have either stifled their hedging practices or cramped their style in any way. Likewise, to DRA's knowledge, there is no evidence of that either. These caps continue to exist at the present time.

There has never been any need for a cap on losses for the obvious reason that in the pre-Katrina days, utilities had the incentive to more actively manage their hedges. The absence of a loss cap is essential in order to ensure that utilities have a clear and distinct disincentive to run up large losses that would saddle ratepayers and not shareholders. Furthermore, the absence of a loss cap would ensure that ratepayers are

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[3] In D.02-06-023, the Commission approved a Settlement Agreement for GCIM year 7, executed in July 2001, by SoCalGas, DRA and TURN that caps the shareholder awards at 1.5% of the actual commodity costs, and a reward of $30.8 million. The GCIM mechanism, if applied, would have resulted in a much higher reward.

[4] D.04-01-047 adopted certain modifications for the CPIM, including capping the annual PG&E shareholder reward at the lower of 1.5% of the actual commodity costs or $25 million.

protected from exposure to a potential rogue trader, as described earlier. Thus, the absence of a loss cap serves as a natural and built-in disincentive for the utilities to run wild with ratepayer monies. The rationale for no cap on losses is therefore just as sound now as it has always been.

Respectfully submitted,

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February 20, 2009

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I hereby certify that I have this day served a copy of **"COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES IN RESPONSE TO THE ADMINISTRATIVE LAW JUDGE'S JANUARY 15, 2009 RULING"** in **R.08-06-025** by using the following service:

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Executed on February 20, 2009 at San Francisco, California.

/s/ R0SEMARY MENDOZA

Rosemary Mendoza

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